

6th October 2010



Gas Distribution Price Control Review 2

The Way Forward

Ofgem open letter

A response by the Gas Forum

Introduction

The Gas Forum represents most of the main gas suppliers to Great Britain. The Gas Forum welcomes the open way in which Ofgem has commenced this review and its parallel review, TPCR5. The Gas Forum is clear that Ofgem's work in price controlling the natural monopolies is the most important area of Ofgem's work.

Before addressing the issues raised by Ofgem, there are some points of process that we wish to make.

Points of process

Consultation

The Gas Forum was pleased with the quantity of consultation carried out by Ofgem in its previous reviews. While the volume of documents can sometimes be difficult to deal with, it is better to have too much as opposed to not enough. That said, the Gas Forum would request that Ofgem continues to strive to give more clarity as to how it has responded to the points made by consultees. While it is clear that comments have been noted, it is not always clear why comments have not been accepted by Ofgem.

Cost of capital

This is one of the key inputs to the final price cap calculation. However, it can sometimes be set late in the process. It may be appropriate to set the cost of capital at the start of the process, with then a clear methodology as to how the cost of capital will change based on market parameters. This would give earlier certainty over this particular input. At the very least, Ofgem should take the lessons from the electricity distribution price control into the next gas distribution price control.

Re-openers

It is possible for the monopolies to request re-openers. In fact, Ofgem has been ready to facilitate re-openers for relatively small amounts of revenue. However, re-openers have been asymmetric in that the users of the network are not able to request re-openers when circumstances move in favour of the monopolies. The Gas Forum has a general level of concern

about the number (too high) and level (too low) of re-openers. Nevertheless, if they are to continue as a regulatory construct, then we request that re-openers are made symmetric. That is, the users of the network are allowed to make formal representations to Ofgem to re-open the price controls. Recent correspondence between Ofgem and the Gas Forum over the Fleetwood entry point shows the scale of this issue.

A related point is that re-openers, if approved, should be subject to a form of “logging up”, with an adjustment, say at the price control mid point. If such re-openers were made asymmetric, with adjustments potentially going both ways, it would bring an element of stability to the price cap levels.

Expertise

The Gas Forum has a general concern that the type of expertise at Ofgem needs to be more detailed, including at a senior level. The monopolies have a natural superiority over the regulator in terms of information. That is understandable. This makes the level of expertise of Ofgem staff of particular importance.

Complexity

Related to the point above is that of complexity. Ofgem has for some time been relaxed about the ever increasing complexity of price controls. Indeed, the Ofgem view has sometimes been that as long as there are enough experts, then complexity per se is not a problem. The Gas Forum disagrees with this view. Complexity causes two problems. First, it acts as a barrier to engagement by the parties that use the monopoly networks. Second, it provides an absolute advantage of the monopolies over Ofgem. We see many meetings where it is the monopolies that are explaining the price control algebra. This cannot be right. If the regulator cannot explain its own price controls then it must indicate that they are too complicated.

Lessons learned

Ofgem carried out an excellent review of DPCR5. However, it is not clear how any of the conclusions of that “lessons learned” exercise have been incorporated into the open letter on DPCR2 or TPCR5. A clear explanation as to how the issues highlighted by Ofgem have been included in an improved Ofgem process should be included in the next Ofgem document.

Issues

We now turn to a brief review of the issues raised by Ofgem in GDPCR2.

Replacement expenditure

The scale of this cost increase is worrying. The Gas Forum urges Ofgem to scrutinise the cost of this programme and there must now be a value for money audit of this programme. If a delay is necessary to fully understand this programme, the Gas Forum would support such an extension.

The Gas Forum would welcome early engagement by Ofgem and the HSE as they review this programme.

The Gas Forum would also request greater clarity as to how the monopolies are being incentivised to complete this programme. We all have many stories of roadworks being started – halting – and then finishing late. It seems that more effort to compel the monopolies to work longer hours, greater shift working and penalties for late completion would be welcome.

The Gas Forum also suggests that the treatment of 50% of replacement expenditure as operating expenditure should be reviewed. There is no rationale that we can see for allowing the network companies to front end load the price profile resulting from such treatment.

Environmental issues

The Gas Forum strongly supports Ofgem’s focus on the role of bio-methane. This work must also extend to addressing the gas quality issues and costs associated with this gas. A more flexible approach to accepting gas of differing qualities would help to facilitate the growth of this important part of the move to a lower carbon economy, provided the costs are understood properly and targeted accordingly.

Demand uncertainty

This issue will become ever more important as energy policy continues to support the connection of intermittent electricity production. In this respect, the drive by Ofgem to remove interruptible capacity seems particularly difficult to understand. The Gas Forum supports efforts by Ofgem to ensure better demand forecasting by the monopolies. However, the Gas Forum also supports a focus on re-introducing demand side flexibility into the gas networks.

Providing for enhanced engagement

The Gas Forum welcomes the Ofgem proposals in this area. It is already evident that the monopolies are making more effort to engage the users of their networks. One area that should be covered by a working group is the efficiency of the networks. This may be covered by the “cost assessment” workstream.

TPCR5

Many of the issues considered by the Gas Forum in GDPCR2 apply equally to TPCR5. The role of flexibility in the gas transportation system as the country moves to rely on intermittent sources of electricity production needs attention. Ofgem refers to the need to consider incentives to reflect the necessary flexibility of the system. In principle, the Gas Forum agrees with this view. However, the Gas Forum considers that building a level of resilience into the system may be more important than a sophisticated incentive based regulatory initiative. The greatest source of flexibility is resilience.

The sale of the gas distribution networks

There is one issue that is not addressed by the issues letter. This is the benefits that were projected when Ofgem allowed National Grid to sell some of its gas distribution networks. The Gas Forum notes that the benefits forecast by Ofgem were relatively small in the impact assessments of the time. Such benefits as were forecast were intended to flow through starting in this forthcoming price control period. It is incumbent on Ofgem to explain and demonstrate that such benefits are now beginning to flow.

Conclusion

The Gas Forum welcomes the opportunity given by Ofgem for engagement at this early stage. We are of course ready to assist Ofgem in any way that we can for this most important of Ofgem's work programmes.